



## DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

Embargoed for Release at 10:00 AM  
February 6, 2002

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STATEMENT OF JOHN B. TAYLOR  
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS  
  
BEFORE THE  
  
SUBCOMMITTEE ON INTERNATIONAL MONETARY POLICY AND TRADE  
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

February 6, 2002

Thank you Chairman Bereuter, Ranking Member Sanders and members of the Subcommittee for inviting me to participate in this hearing on the current economic situation in Argentina.

The people of Argentina are facing extremely trying times. Throughout this difficult period, President Bush has made it clear that Argentina is an important friend and ally of the United States of America. We want our allies to be strong leaders of free democracies and free markets. Argentina should be an engine of economic growth in our hemisphere. It is important that Argentina succeeds.

In order to understand the current situation in Argentina, I think it is helpful to begin by reviewing some of the key economic developments in Argentina during the last decade.

### ***The Economy of Argentina in the 1990s***

In the early 1990s, the government of Argentina undertook a series of important reforms in economic policy, including monetary policy, fiscal policy, structural policy, and international trade policy. Perhaps most dramatic and immediately noticeable was the change in monetary policy. A highly inflationary monetary policy was replaced by a new "convertibility law," which pegged the peso one-to-one with the dollar and largely prevented the central bank from financing the government's budget deficit by printing money. Fiscal policy was also brought into better

control with a decline in deficits. On the structural side, a comprehensive privatization program was implemented through which a number of inefficient state-owned enterprises were privatized. Moreover, barriers to international trade and investment were reduced and Argentina's financial sector was opened to foreign investors.

These market-oriented reforms produced very impressive results. Hyperinflation—which had risen to over 3000 percent—was brought to a quick end by the convertibility law. Economic growth turned around sharply: after falling during the 1980s, real GDP began growing at over 4 percent per year. Investment and exports grew particularly rapidly. The sharp increase in economic growth was even more remarkable given the very rapid disinflation that was occurring at the same time.

However, starting in the late 1990s there were a number of policy setbacks and external shocks which sharply reduced economic growth in Argentina and ultimately led to the financial crises in 2000-2001 and the current halt to economic activity.

First, government budget deficits began to increase, an indication that fiscal discipline had begun to wane. Government spending at the federal and provincial level increased faster than tax revenues. These deficits could not be financed by money creation because of the convertibility law. Instead, they were financed by borrowing in both the domestic and the international capital markets; however, as the government's debt began to rise and raise questions about sustainability of the debt, risk premia rose and increased interest rates. Eventually the higher interest rates put additional pressure on the budget deficit and held back economic growth.

Second, the low inflation of the early-to-mid 1990s turned into persistent deflation which also had negative effects on economic growth. In addition, the currencies of Argentina's major trading partners in Europe and Brazil depreciated relative to the dollar, and therefore relative to the Argentine peso. This effective appreciation of the peso led to a deterioration in Argentina's competitiveness which, along with the higher interest rates, further held back economic growth.

Third, persistent expectations of depreciation of the peso caused interest rates on peso loans to be higher than dollar interest rates. Whenever policy actions were taken that raised questions about central bank independence or about the convertibility law, market expectations of depreciation increased causing domestic interest rates to rise further.

As low economic growth persisted into 2000, concerns began to grow that a vicious cycle of low tax revenues and continued government spending increases would lead to rising interest rates, which would further slow the economy. Following the political turmoil in October 2000 when Vice President Alvarez resigned, Argentina's borrowing costs soared and rolling over government debt became more and more difficult. Renewed plans to reduce the budget deficit brought interest rates down temporarily, but by February 2001 it was clear that further actions needed to take place. The Argentine government introduced a number of policy changes and finally decided to create a rule – the zero deficit law – in the summer of 2001 to try to provide confidence about the government's seriousness in getting its fiscal house in order.

Eventually, however, it became clear that these changes to the budget were not working. Many market participants considered the government's economic plan to be unsustainable, and interest rates on government debt began to increase sharply. By November, it was apparent that the government's debt would have to be restructured and, indeed, President de la Rúa took the step of announcing that such a restructuring would take place.

As the restructuring effort was underway, the uncertainty about its impact on the banking system led to increasingly large deposit withdrawals from banks and international reserves began to fall. In order to stop the withdrawals and the decline in reserves, the government imposed severe restrictions on such withdrawals in December. Soon after the restrictions were imposed, social and political protests turned violent, leading to the resignation of President de la Rúa and his Ministers.

Economic circumstances in Argentina deteriorated after the imposition of the restrictions on deposit withdrawals. The lack of a functioning payments system led to a virtual halt of much economic activity. The shortage of liquidity is hindering economic growth and underlies much of the social frustration. The Duhalde government, which took over in January, is in the process of gradually removing these restrictions and at the same time moving to a flexible exchange rate system.

It is of course up to the government of Argentina to work out the details of a set of economic policies that will increase economic growth in a sustainable way. Indeed, it has begun to lay out the broad outlines of such a policy strategy in the last few days, and, as Secretary O'Neill said on Monday, we are encouraged that the Argentine Government is taking substantive steps to address its economic problems. In terms of economic policy, the government must still develop a growth-oriented tax system and a lasting budget arrangement with the provinces that is based on realistic assumptions about available sources of non-inflationary financing. The central bank must establish a transparent, rules-based monetary regime that will keep inflation from rising as the convertibility law did in the 1990s. The government must begin discussions to restructure its debt. And banks must be recapitalized so that lending to the private sector can resume, which in turn will strengthen growth, investment, and job creation.

### ***Summary of IMF Programs***

During the period of time discussed above, the government of Argentina had several programs with the International Monetary Fund (IMF). In March 2000, Argentina obtained a \$7.4 billion IMF program. The Argentine government treated the program as "precautionary," meaning that the government did not intend to draw upon it. However, starting in the summer of 2000, the growing concern in financial markets was that the persistent Argentine recession was setting up the potential for a financial crisis.

In December 2000, Argentina drew on \$2 billion from its IMF program, and the next month the IMF approved an additional \$6.3 billion for Argentina's program, bringing the total program size to \$13.7 billion. As a condition for the January package, the Argentine government agreed to a series of structural measures in the area of fiscal, pension and health care reforms to help develop a sustainable fiscal position in the medium-term and to build investor confidence.

In August 2001, the IMF provided Argentina with a further augmentation of \$8 billion. Of this amount, \$5 billion was to bolster reserves in the central bank to counter a substantial fall in deposits during the summer. The remaining \$3 billion could be used to support a voluntary, market-based debt operation and thereby begin to address Argentina's debt sustainability problem. However, when tax revenues continued to fall short and the government failed to reach an agreement on transfers to the provinces, it became increasingly clear that the government was not going to be able to meet its fiscal targets and had no other sources of financing. This fueled concerns about the government's ability to service its debt, particularly to domestic banks, and eventually prompted an accelerated run on the banking system.

In December, IMF staff determined that Argentina was not going to make its fiscal targets for the fourth quarter that were agreed upon in August and that its program was no longer sustainable. Thus, the IMF could not complete its review and consequently did not disburse a loan tranche in December 2001.

### ***U.S. Policy***

Since the Bush Administration took office, we have remained in close engagement with the IMF, the G-7, and other leaders in the region about the financial and political problems that Argentina faces. Moreover, we have and will remain fully engaged with Argentina -- our neighbor, friend, and strong ally. As President Bush has stated and Secretary O'Neill has reiterated, once Argentina has designed a sustainable economic program, we are prepared to support it through the international financial institutions.

Our engagement with the International Monetary Fund and the government of Argentina during the last year should be viewed in the context of our overall approach to emerging markets. During the last four years the flows of capital to the emerging markets have declined sharply, and it has been the intent of the Bush Administration to reverse this trend by reducing the frequency of financial crises of the kind that we have seen in Argentina.

Of course the ideal would be to prevent crises such as the one in Argentina from occurring. This requires not only early detection of policies or of external shocks that could cause crises, but also the resolve to take actions to reverse such policies or counter such shocks. The Bush Administration has encouraged the IMF to strengthen its capacity to detect potential troubles on the horizon, and to be willing to warn countries that are heading down a dangerous path to take appropriate action. Effective communication with markets is also key. And the IMF can be more effective and credible in undertaking these tasks if it focuses on issues that are central to its expertise -- notably strengthening monetary, fiscal, exchange rate, financial sector, and debt management policies. In the last decade, the IMF became too involved in matters outside of these core areas.

I hope the emerging market asset class grows much more in the future as the rates of economic growth in developing and emerging market countries rise. But we have to recognize that official sector resources cannot possibly grow at such a high rate that we can continue with very large official finance packages to deal with emerging market debt crises as in recent years.

There will inevitably be limitations on the use of official sector resources. Moreover, in order to reduce bailouts of private investors it is necessary to limit the use of official resources, especially in cases where debt sustainability is in question. We must therefore gradually move in the direction of less reliance on large official finance packages.

An important change has been occurring in emerging markets and we have encouraged this change as part of our approach to emerging markets. Investors are increasingly differentiating between countries and markets based on fundamental economic assessments -- judgments that are facilitated by better information. This differentiation is reducing contagion from one country to another, as exemplified most recently by the relative stability in other emerging markets over the past few months despite the crisis in Argentina. Emphasis on the risk of contagion by the official sector in the past led to the expectation on the part of investors and emerging market governments that the official sector would bail them out. That encouraged excessive risk-taking and gave rise to the very conditions that made financial crises more likely. Changing this mindset has been an important priority, and, I think, an area where we have made some progress.

One important challenge that remains is to explore options to promote more orderly sovereign debt restructurings. The official sector should not encourage countries to default on their debts, but we recognize that restructuring can and will happen in certain cases. At the moment, there is a great deal of uncertainty about the process involved in such restructurings. It is important to find a way such that when a sovereign debt restructuring occurs, it does so in a more orderly manner that treats debtors and creditors fairly and reduces the scope for arbitrary, unpredictable official action.

Thank you again for this opportunity to speak with you. I look forward to hearing your views and answering your questions.